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C O N F I D E N T I A L SECTION 01 OF 02 BEIJING 003277

SIPDIS

STATE FOR EAP/CM, EAP/TC, EAP/EP, EEB/TPP/BTA
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TREASURY FOR OASIA/WINSHIP AND PISA
COMMERCE FOR ITA/MAC/AP

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TAGS: EFIN EINV EIND CH
SUBJECT: PRC: PRIVATE EQUITY WON'T HELP SOE PRIVATIZATION

REF: (A) 08BEIJING3363 (B) BEIJING 002952 (C)
SHANGHAI 000410 (D) SHANGHAI 000191

Classified By: Classified By: Econ Minister Counselor William Weinstein
. Reasons: 1.5 (b) and (d).

¶1. (C) SUMMARY: Contacts in major U.S. private equity (PE) firms in China agreed that using PE funds to privatize SOEs was a losing bet, and that new "private" equity funding coming out of SOEs would be a danger to the industry, in separate meetings with Econoffs over the past two months. At least two of the PE firms said their negative experiences in attempting SOE purchases had dissuaded their firms from pursuing other such opportunities. This is the third in a series of cables regarding China's nascent domestic Private Equity (PE) industry, the opportunities and challenges facing foreign PE firms in China, and Beijing's actions to shape the regulatory landscape. EconOffs in October and November 2009 met with industry experts from both U.S. and Chinese private equity firms to discuss the dynamics between PE and state-owned enterprises (SOEs). END SUMMARY.

¶2. (SBU) U.S. PE firm Carlyle's Hong Kong-based Director Eric Zhang told EconOffs on November 10 that Carlyle has not attempted an SOE buyout since its failed attempt to purchase heavy equipment maker XCMC (ref A) in 2007. Despite smooth sailing through most of the process, political sensitivities caused regulators to deny the deal, according to Zhang. In the future, Zhang said, Carlyle would only consider SOEs if it could buy a significant majority with "meaningful control" (i.e., 25-30 percent) that allowed them to participate in budget and project decisions but did not put them in the driver's seat.

¶3. (SBU) Zhang said that after 2007, 90 percent of Carlyle's investments had been directed into private entities rather than privatizing SOEs. He said SOE privatization just became too much trouble to get approved, and that too much money was involved with too many uncertainties. Zhang noted "we learned our lesson, and don't want to repeat the XCMC process."

¶4. (C) Wang Wenyong, a Beijing-based vice president of a foreign PE firm, concurred, noting that although he originally pitched SOE privatization as a reason to invest in China, in practice this method was prohibitively difficult. He told EconOffs on November 27 that his firm had attempted to purchase a chain of state-run hotels, but was blocked in the due diligence phase from reviewing certain portions of the business's books. The Chinese managers told him these portions were connected to "important officials," and could not be reviewed or purchased by investors. The deal fell

apart at this stage.

¶5. (SBU) EconOffs on November 4 also met with Chinese PE firm Hony Capital CEO John Zhao, who proved to be the most optimistic vis--vis SOE privatization. Zhao said that Hony, which was one of the largest PE firms in China, was willing to buy SOEs, as long as the transaction occurred in one of two ways. It must either take total control through a 100 percent buyout, or it must become the second largest shareholder after the government, and set up the management team as the third largest shareholder. The combined shares of Hony and the management team must be greater than the government's shares, so that Hony and the management team could overrule the state's decisions if necessary.

SOEs GETTING INTO PE

¶6. (C) EconOffs' industry contacts concurred that not only were PE funds not participating in SOE privatization, but that the reverse was beginning to occur. SOEs increasingly were forming their own "PE" funds and purchasing smaller private enterprises for themselves. Wang noted that investments from SOE-backed funds "were going to spoil the party" by crowding out private investment. He cited the more than 150 funds already established by SOEs, including 3 by China International Trust and Investment Corporation (CITIC). Hony's Zhao further opined that the financial crisis has discouraged China's state-owned banks from lending to small and medium-sized enterprises (SMEs), and encouraged them to spend their stimulus funds on SOEs because they have an implied guaranteed rate of return. (COMMENT: This increase of funds to SOEs is likely to drive further purchases of

private companies. END COMMENT) Wang also noted, however, that this trend would be short-lived as many of these deals would likely result in losses to the state, which would reverse the cycle by divesting itself of underperforming businesses.

7.(C) COMMENT: The trend toward nationalization of smaller private firms using "PE" funds run by SOEs suggests a fundamental misunderstanding of the private equity industry. SOE's end goals (e.g., to list them in an IPO, resell them to a third party, or permanently bring them into the SOE fold) for the companies they buy remain unclear. Whatever the goal, the results will remain constant: private firms bought by SOEs may receive infusions of government capital, but innovation is likely to be stymied by lack of competition and incentives. END COMMENT.
HUNTSMAN